

PROPOSED RESOLUTION

Resolution W-5190
WD

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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

WATER DIVISION

RESOLUTION W-5190
May 16, 2019

RESOLUTION

(RES. W-5190) RESOLUTION GRANTING HILLVIEW WATER COMPANY AUTHORITY TO BORROW UP TO \$3,412,499 FROM A LENDING INSTITUTION; TO ENCUMBER UTILITY ASSETS IN CONNECTION WITH THE LOAN; TO INSTITUTE A CUSTOMER SURCHARGE TO PAY OFF THE LOAN; AND TO ESTABLISH A BALANCING ACCOUNT TO TRACK SURCHARGE COLLECTIONS, LOAN PAYMENTS, AND RELATED FEES.

SUMMARY

This Resolution grants the authority requested of the Commission by Hillview Water Company (HWC) in its Advice Letter (AL) No. 119 and Supplemental AL No. 119-A.

Pursuant to Public Utilities Code §§ 816 through 851, Decision (D.) 93-11-066, General Order (G.O.) 96-B, and Rule 33 of the Rules of Practice and Procedure, HWC seeks authorization in AL No. 119 to secure a \$2,152,499 loan to be paid by customer surcharge to pay for the tax liability arising from receipt of grant funds which are now taxable pursuant to the Tax Cuts and Jobs Act of 2017 (the Act), and to establish a balancing account to track monies collected and costs.

On January 31, 2019, HWC filed Supplemental AL No. 119-A to request authorization for an additional \$1,260,000 loan to be paid by surcharge to pay for outstanding construction costs now due that has not been reimbursed by the grant funding agency. HWC also requested authorization in Supplemental AL No. 119-A to encumber utility assets in conjunction with the loans and to establish another balancing account for the additional loan.

This Resolution authorizes the following: 1) grants HWC authority to borrow up to \$2,152,499 from a lending institution (Primary loan) to pay the tax liability arising from

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receipt of grant funds and loan costs; 2) grants HWC authority to borrow up to \$1,260,000 from a lending institution (Secondary loan) to pay outstanding construction costs pending receipt of reimbursement from grant funds and loan costs; 3) grants HWC the authority to establish a customer surcharge to generate funds to make payments of principal and interest on the loans, cost of issuance, and related fees; 4) allows HWC to encumber utility assets in connection with the loans; and 5) requires HWC to establish two balancing accounts in the utility's Preliminary Statement to track monies collected and costs pertaining to the Primary and Secondary loans.

BACKGROUND

HWC, a California corporation, is a Class C water utility subject to the jurisdiction of this Commission. HWC has four service areas located in the foothills of eastern Madera County, southwest of Yosemite Park. HWC operates four separate water systems: the Oakhurst (Sierra Lakes and Forest Ridge), the Hillview Goldside, the Raymond, and the Coarsegold Highlands water systems, currently providing water service to approximately 1,470 metered customers.

HWC's water system consists of structures, wells, pumping equipment, reservoirs, tanks, standpipes, water mains, water treatment plant, meters and hydrants.

In its Income Statement for the year ending December 31, 2017, HWC reported that it generated operating revenues of \$2,324,148 and net income of \$307,999. The Balance Sheet as of December 31, 2017, as reported, is summarized below:

Table 1
Hillview Water Company
Balance Sheet as of December 31, 2017

<u>Assets</u>	<u>Amount</u>
Total Utility Plant	\$25,636,912
Accumulated Depreciation/Amortization	<u>(6,128,360)</u>
Net Utility Plant	\$19,508,552
Current and Accrued Assets	1,202,007
Deferred Charges	<u>38,137</u>
Total Assets	<u>\$20,748,696</u>
Liabilities & Equity	

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Corporate Capital and Retained Earnings	\$ 1,069,537
Long-Term Debt	4,064,078
Current and Accrued Liabilities	6,530,483
Deferred Credits	922,140
Advances for Construction	
Contributions in Aid of Construction	11,287,533
Accumulated Amortization of Contributions	<u>(3,125,075)</u>
Total Liabilities & Equity	<u>\$20,748,696</u>

In 2017, HWC's utility plant included construction work in progress – Grant Funds of \$12,384,106.

The outstanding \$4.06 million long-term debt, shown above includes a \$3,408,447 Safe Drinking Water State Revolving Fund (SDWSRF) loan, authorized by Decision (D.) 02-11-015 dated November 7, 2002, which is currently being paid through a surcharge. This loan was used to finance the construction of new wells, new raw water transmission line, new treated water transmission line, upgrade of treatment plants, new storage tank, and other improvements in the Oakhurst water system.

By Resolution (Res.) W-4633 dated February 15, 2007, the Commission authorized HWC to secure an additional \$400,000 under the SDWSRF due to increased construction costs. The surcharge was adjusted accordingly.

HWC's last general rate increase became effective January 1, 2016, pursuant to Res. W-5070. The Commission authorized an increase of \$358,559 or 23.01%, which is estimated to provide a Rate of Margin of 20.21%.

Res. W-5070 stated that HWC's Oakhurst and Raymond water systems were under Compliance Orders from the State Water Resources Control Board (SWRCB) Division of Drinking Water (DDW) for not meeting the primary drinking water standards for arsenic and uranium.¹

¹ Compliance Orders No. 03-11-97O-002, No. 30-11-12O-002, and No. 03-11—09O-001.

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A. State Grants

In 2016 HWC obtained approval from the SWRCB for the engineering plans and system specifications for the required treatment facilities and system improvements for the removal and treatment of the arsenic, uranium and nitrate from the source supply for the Oakhurst and Raymond water systems. The estimated cost of the project is \$14 million.

Subsequently, HWC received approval for grant funds from the SWRCB for the construction of the required treatment facilities and has executed funding agreements for grants under Chapter 4a.1 of the Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002 (Prop 50),² the California Public Resources Code, Section 75022 of the Safe Drinking Water, Water Quality and Supply, Flood Control, River and Coastal Protection Bond Act of 2006 (Prop 84),³ and the Program Drought Emergency (PDE).⁴

² Prop 50 was passed by California voters in the November 2002 general election and Assembly Bill 1747 was signed into law in August 2003. For the first time, California investor-owned water utilities were invited to apply for state grant funds. Previously, water quality bond measures specifically denied investor-owned water utilities grant eligibility. Receipt of grant funds by Commission-regulated water utilities will allow the utilities and their customers to benefit from cost-free funds for needed investments in water supply, treatment, and security.

³ Prop 84 was passed by California voters in the November 2006 general election and Senate Bills SB X2 1 and SB 732 were signed into law in September 2008. Prop 84 grant funds are intended for the prevention and reduction of groundwater contamination.

⁴ Allocated pursuant to the Budget Act of 2016 and SWRCB Resolution No. 2016-0039. The purpose of the emergency drinking water funding is to address drinking water emergencies to communities in need of funds due to limitations or lack of access to safe, reliable, and affordable drinking water.

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The grant funds are intended for the following purposes:

Table 2
State Grant Funds

Purpose of Funding	Hillview District	Prop 50	Prop 84	Program Drought Emergency (PDE)	Total
Feasibility	Oakhurst Sierra Lakes		294,334.05		
Construction	Oakhurst Sierra Lakes		4,705,663.00		
Acquisition of Wells, Connections	Oakhurst Sierra Lakes			80,637.00	5,080,634.05
Construction	Oakhurst Forest Ridge	1,998,600.00			1,998,600.00
Feasibility	Raymond		494,476.57		
Construction	Raymond		4,505,523.00		
Construction	Raymond*	1,327,896.00			
Acquisition of Wells, Connections	Raymond			123,030.00	6,450,925.57
Total Funding		3,326,496.00	9,999,996.62	203,667.00	13,530,159.62
<i>* The Raymond Prop 50 construction grant was originally \$2 million but due to reduction in estimates currently totals \$1,327,896.</i>					

The Prop 50 grant funds will address the arsenic, uranium and nitrate water quality issues for the HWC's Raymond water system. The capital improvement projects include: 1) installation of a 120 gallons per minute (gpm) arsenic and uranium treatment facility, including the addition of back-up power generation for the plant; 2) addition of 240,000 gallons of water storage facilities; 3) equipping the two new wells with mobile back-up power generation and a sludge truck for the transferring of the backwash; 4) addition of a pressure system; and 5) addition and replacement of approximately two miles of new feed and distribution mains.

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In addition, the Prop 50 grant funds will be used for the 1) replacement of HWC's Sunnydale Radial well with three new wells; 2) installation of a larger water treatment facility at Forest Ridge with a capacity of 600 gpm for the removal of iron and manganese; and 3) installation of 400,000 gallons of water storage for blending the treated water.

According to HWC, the Coarsegold water system will benefit from the Prop 50 project since the existing 250 gpm of the iron and manganese treatment facility at Forest Ridge will be moved and installed on this water system. Iron is a Secondary Drinking Water Standard which is exceeded in Coarsegold. The treatment plant from Forest Ridge P-50 will bring the Maximum Contaminant Levels (MCLs) into compliance for iron and manganese.

The Prop 84 grant funds will be used for feasibility studies for Sierra Lakes and Raymond districts, construction projects at Raymond facility, and for capital improvement projects at HWC's Sierra Lakes facility that includes: 1) installation of a 1,250 gpm arsenic, iron, and manganese removal plant; 2) installation of a 1,000 gpm uranium removal treatment plant; and 3) addition of 400,000 gallons of finished water storage facilities.

According to HWC, the Goldside water system will benefit from the Sierra Lakes project since it will receive the existing 550 gpm iron and manganese water treatment plant from the Sierra Lakes water system. Iron and manganese are Secondary Drinking Water Standards, which are exceeded by 4 wells in the Goldside water system.

The PDE grant funds will be used for the acquisition of wells and for service connections of customers with private wells that dried up during the drought and maintain support of water provision for fire.⁵

The State's grant funding agreements provide that funds may be used only for eligible project costs as approved by the State. Some conditions follow:

⁵ Because of several years of California drought, before and during construction of the grant projects, and delays in construction that were out of the control of HWC or the SWRCB, the Oakhurst Sierra Lakes and Raymond water systems required PDE funding for the purpose of accelerating acquisition of grant project wells and facility improvements to allow the water systems to adequately serve customers through the drought and for the duration of the construction.

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1. HWC (Supplier) shall at all times comply with, and require its contractors and subcontractors to comply with, all applicable federal and state laws, rules and regulations, permits, and all applicable local ordinances, including, but not limited to, environmental, labor, procurement and safety laws, rules, regulations, permits, and ordinances.
2. Supplier shall not make any change in the Project without receiving prior written approval from State.
3. Supplier shall request disbursement by submitting to State a claim(s) for incurred Project costs.
4. Following the review and approval of a claim by State, it will disburse to Supplier the approved amount, subject to any retention required pursuant to the terms of the Agreement, and subject to the availability of funds.
5. All funds disbursed to Supplier shall be used solely to pay eligible project costs.

By letter dated March 1, 2019, the SWRCB gave HWC conditional approval to operate the newly constructed Raymond water treatment facility until such time that a domestic water supply permit is completed and issued to HWC by the SWRCB's DDW.

By letter dated March 1, 2019, the SWRCB gave HWC conditional approval to operate the newly constructed Sierra Lakes and Forest Ridge water treatment facilities until such time that a domestic water supply permit is completed and issued to HWC by the SWRCB's DDW.

These approvals allowed HWC to start full operation of all three new water treatment plants until new Public Water System Permits are issued.⁶

⁶ The SWRCB's DDW has chosen not to amend HWC's current permits because of the significant operating changes required by all the new treatment plants. The Division has thoroughly reviewed the plans, verified construction and specifications, complied with State and Federal regulations, and attested that the treatment plants are complete and safe to operate and fulfill the purpose of the plan and design to produce clean, safe, wholesome potable water for the Oakhurst Sierra Lakes and Raymond water systems.

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B. Commission's Rules Governing Receipt and Use of All Future State Grant Funds Received by All Classes of Regulated Water Utilities

D. 06-03-015 dated March 2, 2006 in Rulemaking 04-09-002 stated that grant-funded plant should be accounted for in the same manner as Contributions in Aid of Construction (CIAC), but as a distinct account and record.⁷ In this decision, the rules adopted are designed to preserve the public interest integrity of future state grant funds by ensuring that investor-owned water utilities and their shareholders do not profit in any way from the receipt of public funds.

CIAC are any items or amounts contributed to a regulated public utility to the extent that the purpose of the contribution is to provide for the expansion, improvement or replacement of the utility's facilities. CIAC includes any property, including money that a utility receives to provide or encourage the provision of service.

HWC's current income tax component of CIAC and Advances is included in its Main Extension, Rule 15 tariff.

C. Tax Reform Act of 1986

In D.87-09-026 dated September 10, 1987, the Commission authorized the methods which utilities may adopt to recover the federal tax imposed upon CIAC and advances pursuant to the Tax Reform Act of 1986. This decision placed the burden of the tax on the contributor or advancer.⁸

Some of the Conclusions of Law included in D.87-09-026 follows:

No. 12 – If a utility is not in a taxable position in the year that it receives a contribution or refundable advance, there is no tax liability. The tax gross-up received from the contributor under Method 2 or Method 5 should then be refunded to the contributor. If a utility collects a gross-up

⁷ D.06-03-015, page 10.

⁸ The income tax component set forth in D.87-09-026 includes federal income tax and state franchise tax. D.87-09-026 authorized all utilities to collect state tax gross-up consistent with the calculation of the federal tax gross up, if California conforms to the federal law.

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calculated using an incremental tax rate that is more than its incremental rate, as determined on a ratemaking basis, the difference between what was and what should have been collected should be refunded to the contributor.

No. 13 - Because California taxing authorities have not yet determined whether California will follow the federal law on taxable contributions, we will not authorize utilities to gross-up contributions for California taxes. We will authorize all utilities to apply the same method they chose for the federal tax gross-up to gross-up for California taxes, when imposed. Should California authorities impose a tax on contributions retroactive to January 1, 1987, we will authorize the utilities to collect that tax from ratepayers for the retroactive period using Method 3.

No. 14 - In addition to the change in the gross-up to reflect potential California conformity legislation, we will also authorize a change to reflect the reduction in the federal tax rate from 1987 to 1988. However, we will not require utilities to reflect other changes in the gross-up rate, unless the changes would increase or decrease the rate by five percentage points.

No. 18 – Utilities should be required to refund the gross-up amounts associated with any contributions which prove to be not subject to tax, plus interest computed at the average three-month commercial paper rate as published in the Federal Reserve Bulletin.

In D.96-10-037 dated October 9, 1996, the Commission modified D.87-09-026 by rescinding Conclusion of Law No.12 and replacing it with a new Conclusion of Law No. 12 that reads: For utilities which elect Method 2, if the utility collects a gross-up using an incremental tax rate that is more than its incremental tax rate as determined on a taxable year basis without consideration of a tax credit or tax loss carry forwards, the difference between what was and what should be been collected should be refunded to the contributor. The same applies to a contributor who is required to pay gross-up on Advances in Aid of Construction (AIAC).

D.96-10-037 stated that in 1990, the California legislature made contributions taxable for California Corporate Franchise Tax (CCFT) purposes, and any tax gross-up in 1990 and subsequent years will include a CCFT component, as well as a Federal Income Tax (FIT) component.

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The enactment of § 1613 of the Small Business Jobs Protection Act of 1996 exempted from federal taxation all CIAC received by all water and sewer utilities after June 12, 1996.

D. The Tax Cuts and Jobs Act of 2017

The Act that became effective after December 22, 2017 reduced the corporate tax rates to one flat rate. The Act includes significant changes to the Internal Revenue Code (IRC), some of which affect the taxability of economic development incentives for businesses and developers. Prior to the Act, IRC § 118 allowed a corporate taxpayer to exclude contributions from non-shareholders (i.e. governmental entities) from their income. Under the new IRC § 118, a corporation receiving an upfront cash incentive can no longer exclude these contributions unless the government makes the contribution as a shareholder. Contribution such as cash grants, public infrastructure and improvement grants are now taxable.

Title 26 U.S. Code § 118 – Contributions to the capital of a corporation provides:

- (a) General Rule – in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.
- (b) Exceptions – for purposes of subsection (a), the term “contribution to the capital of the taxpayer” does not include –
 - (1) any contribution in aid of construction or any contribution as a customer or potential customer, and
 - (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

To-date the California Legislature has not passed legislation to make California tax provisions conform to the Federal model. It will require two-thirds majority for any California legislation to raise taxes and it may take a year or two to do so, as what happened previously during the Tax Reform Act of 1986.

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NOTICE AND PROTESTS

Pursuant to G.O. 96-B, Water Industry Rule 4.1, on January 14, 2019, HWC served its AL No. 119 on its service list. Notice of AL No. 119 was made by publication in the Commission's Daily Calendar of January 21, 2019. On January 31, 2019, HWC served its AL 199-A on its service list. Notice of AL No. 119-A was made by publication in the Commission's Daily Calendar of February 6, 2019.

On March 6, 2019, HWC notified its customers by mail that the three water treatment plants funded by grants have been cleared by the SWRCB to go on line. However, due to the current taxability of grants from a governmental entity, and the current State reimbursement problem, it became necessary for HWC to procure loans in order to pay the tax and to liquidate outstanding vendor's costs until reimbursements are received from the State. To provide the lender a dedicated source of payment, HWC proposes a customer surcharge to pay the loans.

On March 7, 2019, HWC published a notice of the proposed loans and surcharges in The Fresno Bee, a local newspaper circulated in Madera County. On March 8, 2019, an Affidavit of Publication was issued by The Fresno Bee.

By e-mail dated March 12, 2019, two customers objected to the proposed surcharge and questioned why the customers should pay for the proposed loans. The customers stated that their current bills already included many surcharges, plus service and meter water fees. Both customers are concerned about the poor quality of water HWC provides.

On March 14, 2019, HWC sent the customers the following explanations summarized below:

1. California have stringent public water system requirements and it gets more and more expensive to maintain and comply with safe drinking water requirements.
2. Grant money is now taxable and HWC did not foresee the tax change but must comply with the new law.
3. The State is temporarily unable to issue grant reimbursement funds.
4. Customers can always check the composition of their bills with HWC.
5. HWC is committed to finding cost alternatives that are in the best interests of customers.

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By e-mail dated March 16, 2019, one customer with a signed petition from 39 Raymond customers protested the proposed surcharge and stated the following:

1. HWC and the SWRCB who attended the town hall meeting stated that the multi-million infrastructure project will be funded by a grant and the customers will bear no costs.
2. The “surprise” tax liability or the taxability of grant funds should be borne by the shareholders as part of doing business.
3. The facilities built by the grant funds should increase the overall value of HWC that is currently being acquired by American Water Company. This makes the company more valuable and profitable to its owners.
4. If the unpaid contractor has a lien on HWC’s equipment, it can by law shut off the water. The community should not be at risk due to the unpaid bills.

By letter dated March 16, 2019, one customer with a signed petition from 20 Oakhurst Customers protested the proposed surcharge arising from the tax liability and the reimbursement delay. The customer suggested that Congress should amend the 2018 tax cuts and grandfather projects funded prior to 2018. Also, the SWRCB should correct the reimbursement glitch so contractors are paid.

On March 20, 2019, HWC explained to the two customers, et. al. that the proposed surcharge is a product of unexpected changes in the 2018 tax cuts and customers will now be supplied water from three new and modern efficient water treatment plants. HWC also indicated that it is committed to finding the lowest cost alternatives and solutions in the best interests of customers.

By e-mail dated March 18, 2019, one customer objected to the proposed increase in his monthly bill, the poor quality of water, and the lack of other water systems that he can choose from.

On March 19, 2019, HWC informed the customer that HWC began operating the new water treatment plants funded by the grants and the test results show that the water produced is completely safe, pure, and in compliance with State and Federal primary and secondary drinking water standards.

The Water Division (WD) acknowledged receipt of the customer protests and informed them that a Resolution will be mailed out for comments.

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DISCUSSION

According to HWC, the change in the law regarding taxability of contribution by any government entity was completely unknown and was totally unforeseen when the grant was applied for in 2016. HWC asserts that the need to construct the treatment facilities were critical due to water quality issues and safety of the water supply. The cost of the treatment facilities project was beyond HWC's financial capacity without funding from grants. This is the reason why HWC utilized the grant funding. The construction of the treatment facilities will put HWC in compliance with the State's water quality standards.

To-date, HWC received \$5,627,763.47 in grant funds prior to December 22, 2017 and received \$5,453,425.55 after December 22, 2017 through December 31, 2018 and expects to receive approximately \$1,872,290.46 in 2019. The \$5,627,763.47 of grant funds received prior to December 22, 2017 would be excluded from taxable income. For the \$7,325,716.01 (\$5,453,425.55 plus \$1,872,290.46) of grant funding received after December 22, 2017, HWC will need to declare this \$7,325,716.01 amount in taxable income because in the Act, there is no longer an exception for the non-taxability of contribution received from governmental entities.

HWC estimates the tax as follows:

Table 2
Tax Impact

Grant funds received prior to December 22, 2017	\$ 5,627,763.47
Grant funds received in 2018	5,453,425.55
Grant funds expected to be received in 2019	<u>1,872,290.46</u>
Total Prop 50 & Prop 84 Grant Funding	<u>\$12,953,479.48</u>
Grant funds received subject to tax	\$ 7,325,716.01
(\$5,453,425.55 + \$1,872,290.46)	
Less: California tax (\$7,325,716.01 x 8.84%)	<u>(647,593.00)</u>
Taxable for federal tax	\$ 6,678,123.01
Federal tax (\$6,678,123.01 x 21.00%)	\$ 1,402,406.00
California tax (\$7,325,716 x 8.84%)	<u>647,593.00</u>
Grand Total Tax Impact	\$ <u>2,049,999.00</u>

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HWC currently has no ability to collect from the State the income tax caused by the receipt of grant funds after December 22, 2017. The funding agreements specifically state that funds may be used only for eligible project costs approved by the State. Grant funds cannot be used for operating expenses, administrative, and taxes associated with grant-funded plant.

In addition to the tax issue, there is a current delay in the processing of invoices for payment of contractor costs by the SWRCB.

HWC is currently winding up two large grant funded portion of the projects and have submitted invoices to the SWRCB for reimbursement of \$1,180,543 of contractors' costs.

According to the filing, HWC has been informed by the SWRCB that due to an undisclosed problem with the granting agency, the reimbursement payments will be delayed for an indefinite amount of time.

HWC has reached out to the SWRCB regarding the payments and the SWRCB has suggested that a bridge loan could be a solution to enable payment to vendors pending the release of grant funding.

HWC does not have the financial ability to pay the tax associated with the grant funds required by the Act and to liquidate the outstanding costs now due to vendors that are part of the Prop 50 and Prop 84 grant funds.

As stated earlier, in March 2019, the SWRCB's DDW gave HWC conditional approval to operate the newly constructed Raymond, Sierra Lakes and Forest Ridge water treatment facilities and declared that the water treatment plants are complete and safe to operate.

If the treatment facilities were not funded by grants but financed by a loan whereby the lender requires a dedicated source of payment, such as the surcharge to repay the loan, the ratepayer's costs would be \$13.5 million compared to HWC's financing request in this filing of \$3.4 million to be recovered via surcharge.

Upon order of the Commission and for proper cause, Public Utilities Code § 817 allows the use of proceeds from the issuance of debt security for purposes reasonably required for the improvement or maintenance of service of a utility. While the commission does not look with favor upon the capitalization of operating expenses and the cost of

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maintaining service, it has the power and will, in extraordinary cases, to authorize securities for that purpose.⁹

The Commission is not a party to the State's grant funding agreements, but considering that HWC is under our jurisdiction, it is the Commission's responsibility to provide the regulated utility the means to comply with the unavoidable tax payment required by the Act and the liquidation of outstanding contractor invoices.

Public Utilities Code § 829 (c) provides that the Commission may from time to time by order or rule, and subject to such terms and conditions as may be prescribed therein, exempt any public utility or class of public utility from Article 5. Stocks and Security Transactions, if it finds that the application thereof to such public utility or class of public utility is not necessary in the public interest. In this instance, the benefits of the free grant funds expended for a public purpose accrue to the public or the ratepayers. Page 5 of Decision 87-09-026 stated:

We are confident that a public utility agency will fulfill its agreement to reimburse the utility for taxes, interest, and penalties should the contribution prove non-exempt. However, should the government agency fail to fulfill its obligation to reimburse we will authorize the utility to be made whole by a charge against the ratepayers.

To further support our authorization in this instance, we provide below some of the rules pertaining to expenses and taxes associated with grant funds adopted by the Commission in D.06-03-015:

1. Utilities must apply to the Commission, either in a general rate case or by separate filing, for authority to collect from their customers for the non-grant-funded investment and for approval of the financing it proposes for this investment.
2. Operating expenses, administrative and general expenses, and taxes associated with grant-funded plant, but not funded with grant funds, shall be allowed in the determination of rates, if determined to be reasonable by the Commission.

⁹ Page 386, West's Annotated California Codes, Public Utilities Code Sections 700 to 1000.

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3. Unless the utility has received authorization from the funding agency, grant funds should not be spent on expenses. Grant funds that are expended for expenses authorized by the funding agency must not be included in the determination of the Results of Operations and the forecast of future expenses in a general rate case. Once grant funds are no longer available and the utility is required to pay for these expenses out of its own funds, then these expenses shall be included in the Results of Operations and the forecast of future expenses in a general rate case.

Our action on this financing matter is one based on extraordinary events that requires extraordinary measures. The treatment facilities funded by grant funds are for the public good. Therefore, it is reasonable to authorize HWC's financing request.

Because a surcharge is requested in conjunction with HWC's proposed loans that will be used to pay for the tax, vendor costs, and loan costs, this type of recovery is comparable to expenses and taxes associated with grant-funded plant that may be included in the determination of rates as permitted in No. 2 above.

The ratepayers ultimately pay for all water system requirements and improvements, regardless of the way they are financed. Additions to utility plant under the traditional ratemaking procedure are included in rate base, irrespective of whether the plant additions are funded by equity or long-term debt. If the utility owners invested their own funds to pay for the water system improvements, they would be entitled to reasonable earnings on such funds.

We are aware that HWC will not be able to obtain the loans until it demonstrates to the lender that it has the source of funds to be used for repayment of the loans, and that such dedicated funds are documented in an order or resolution.

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To provide for the principal, interest, and fees, HWC proposes the following surcharges that will be in direct proportion to the capacity of each customer's meter or service connection:¹⁰

Table 3
Estimate Surcharge

<u>Size of Meter</u>	<u>Primary Loan Surcharge Per Month</u>	<u>Secondary Loan Surcharge Per Month</u>	<u>Total Surcharge Per Month</u>
5/8"x3/4"	\$ 5.12	\$ 3.00	\$ 8.12
3/4"	\$ 7.68	\$ 4.49	\$ 12.17
1"	\$ 12.79	\$ 7.49	\$ 20.28
1-1/2"	\$ 25.59	\$ 14.98	\$ 40.57
2"	\$ 40.94	\$ 23.97	\$ 64.91
3"	\$ 76.76	\$ 44.93	\$121.69
4"	\$127.94	\$ 74.89	\$202.83
6	\$255.88	\$149.78	\$405.56

The current monthly bill for a 3/4-inch metered customer using approximately 14 ccf of water would increase from \$119.89 to \$132.06, or 10.2%.¹¹

The monthly surcharge to be imposed during the 25-year term of the Primary loan is estimated to generate \$166,423.00 annually. Approximately 90% of HWC's metered customers have 3/4" connections.

The monthly surcharge to be imposed during the 25-year term of the Secondary loan is estimated to generate \$97,418.00 annually.

When the SWRCB resolves its reimbursement problems and the payment to contractors is resumed, HWC should use all the reimbursement amounts as payments to the

¹⁰ Assuming a 25 year fully amortized loan at 6% interest rate.

¹¹ The current monthly bill includes the monthly service charge of \$46.69, a quantity rate of \$3.695 per 100 cubic feet, labor and water treatment operations surcharge of \$13.91 approved under Advice Letter No. 113, and the Safe Drinking Water State Revolving Fund surcharge of \$7.56 authorized by Res. W-4633 (\$119.89 = \$46.69 + (14 x \$3.695) + \$13.91 + \$7.56).

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Secondary loan. The proposed Secondary loan surcharge will be temporary in nature and should be terminated as soon as the outstanding contractor's costs plus loan costs are fully liquidated.

Once the Secondary loan is paid off, the monthly bill for a $\frac{3}{4}$ -inch metered customer using approximately 14 ccf of water would decrease from \$132.06 to \$127.57, a decrease of 3.4%.

Since the interest rate that will apply to the proposed loans will be determined at the time of execution, the proposed surcharges shown above are estimates and consequently may change. Accordingly, the surcharges will be calculated using the same methodology used in calculating the surcharges above but will be adjusted to reflect the actual interest rate and any other changes to the assumptions underlying the above proposed surcharges. The advice letter shall be filed as a Tier 2 Advice Letter to allow for staff review and approval of the surcharge filing.

The Commission has also ordered utilities to impose a service fee for new service to vacant and undeveloped lots when the Commission authorizes loan surcharges. We recommend HWC be granted authority to impose a service fee for future customers who will benefit from the treatment facilities. The benefits include potentially increased property values and the availability of water, furnished by a public utility which meets health standards. The amount of the service fee, subject to a maximum amount of \$2,000, is the accumulated total of the loan surcharge from its inception to the time of service connection. Per Standard Practice U-13-W – Water Company Filings for Financing, Section B.9: SDWSRF loans, as well as past authorizations for similar types of financing, this Commission has limited the service fee to \$2,000 per customer. Only the monthly surcharge applies thereafter.

To the extent that the source of funds requirement remains a condition in this matter, HWC's financing request should be granted with a surcharge authorization.

Therefore, it is reasonable to authorize HWC to impose a surcharge on its customers and a service fee to future customers who will benefit from the treatment facilities.

The surcharge method of recovery ensures that the loans will be repaid without financial stress to the water utility. The surcharge serves only to repay the loan and will not generate any profit to the utility owners.

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In order to ensure proper treatment of the surcharge and plant financed, the Commission will impose the following conditions:

- a. The loan repayment surcharge shall be separately identified on customers' bills.
- b. The surcharge to repay the loan shall continue until the loan is fully paid.
- c. Surcharge revenues shall not be commingled with other utility revenue.
- d. HWC shall establish separate balancing accounts for the Primary and Secondary loans to track surcharge collections, loan payments, and bank and loan related fees.
- e. HWC shall deposit all surcharge revenues with a fiscal agent approved by the lender (Trust Account). Such deposits shall be made within 30 days after the surcharges are collected from customers.
- f. When the SWRCB resolves its reimbursement problems and the payment to contractors is resumed, HWC shall use the receipt of all the reimbursement amounts as payments to the Secondary loan. The proposed Secondary loan surcharge will be temporary in nature and shall be terminated as soon as the outstanding contractor's costs plus loan costs are fully liquidated.
- g. Any surplus accrued in the Primary loan Trust Account and the Secondary loan Trust Account shall be refunded or applied on behalf of the customers when ordered by the Commission.
- h. HWC shall file a Tier 2 Advice Letter to implement the surcharge and the service fee, updated for the correct amounts, at an appropriate time prior to the first loan payment and include in the filing a request to establish a balancing account for each of the Primary and Secondary loans.
- i. HWC shall file with the Water Division (WD) a copy of the loan documents within 15 days of execution.
- j. HWC shall deduct the depreciation expenses for income tax purposes and flow through to customers any benefits derived from the tax deduction in the most direct fashion possible.
- k. The items paid for by the authorized surcharge shall be excluded from rate base in other ratemaking proceedings.
- l. The surcharge for each of the loans shall be terminated upon full payment.
- m. HWC shall file annually, a report to the WD stating the changes in the number of connections by type of customer and by size of connection, the amount of surcharge collected, the loan payments made, the outstanding balance of the loan, and the overages or shortages in the balancing

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account. If the surcharge requires adjustment, HWC should file a Tier 3 advice letter for an increase and a Tier 2 advice letter for a decrease.

HWC's estimate of the grant tax liability includes a CCTF of 8.84%. Considering that the California Franchise Tax Board has not yet conformed to the federal tax overhaul, the Commission will require in this financing authority the following conditions:

1. If HWC collects a gross-up using an incremental tax rate that is more than its incremental tax rate as determined on a taxable year basis without consideration of a tax credit or tax loss carry forwards, the difference between what was and what should have been collected should be refunded to the ratepayers.
2. As appropriate and on a timely basis, HWC shall update its Main Extension, Rule 15 to reflect changes in FIT and CCFT components for purposes of the tax gross-ups for contributions and advances.

By Application (A.) 18-04-025, filed April 25, 2018, the California-American Water Company, HWC, Roger Forrester, and Jerry L. Moore and Diane F. Moore, as trustees of the Jerry Moore and Diane Moore Family Trust requests for an order authorizing the sale of all shares of HWC to California-American Water Company and approval of related matters. This matter is currently active, and no decision has been rendered.

Decision 06-03-015 § 6.2 Sale to Regulated Water Utility, addresses the Raymond customers' concern that the infrastructure funded by the grant would increase the overall value of the water system if HWC is acquired by another water company.

In D.06-03-015, the Commission adopted rules to preserve the public interest integrity of state grant funds by ensuring that investor-owned water utilities and their shareholders do not profit in any way through the receipt of public funds. Some of the rules adopted follow:

1. If the asset to be transferred has been paid for with grant funds in whole or in part, the transferring utility may not receive compensation for that

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portion of the asset that has been funded with grant funds, and the purchasing utility shall record the transfer to a non-ratebase asset.¹²

2. The non-grant funded portion of the asset, if any, should transfer at fair market value pursuant to Public Utilities Code § 2720.¹³
3. The selling utility does not receive compensation at the disposal of contributed plant.
4. The purchasing utility does not earn a return on either the existing book value or any premium to account for market value at the time of acquisition since the contributed plant is recorded at its existing cost (not inflated for market value at the time of sale) in contributions, which is deducted in the calculation of rate base.
5. The selling utility does not expend its own funds for the contributed portion of the plant and therefore should not be reimbursed for or profit from its sale.
6. Operating expenses, administrative and general expenses, and taxes associated with grant-funded plant, but not funded with grant funds, shall be allowed in the determination of rates, if determined to be reasonable by the Commission.

Decision 06-03-015 ensures that investor-owned water utilities and their shareholders do not profit in any way through the receipt of public funds.

We find no substantive evidence from the customers' objections to HWC's proposed loans and the surcharge rates to pay the loans that should dissuade us from considering HWC's requests in AL No. 119, as supplemented. The proposed Primary loan is a product of the unexpected tax liability caused by the Act and HWC and the SWRCB could not have foreseen the tax liability of grants because since 1996 all water and sewer

¹² Current Standard Practice U-38-W issued January 2018 changed the non-ratebase asset to Account 265 – Contributions in Aid of Construction.

¹³ Section 2720 provides that the Commission shall use the standard of fair market value when establishing the rate base value for the distribution system of a public water system acquired by a water corporation. If the fair market value exceeds reproduction costs... the Commission may include the difference in rate base for ratesetting purposes if it finds that the additional amounts are fair and reasonable. The Commission shall consider whether the acquisition of the public water system will improve water system reliability, whether the ability of the water system to comply with health and safety regulations is improve, whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available, and whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable.

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utilities were exempted from federal taxation on all CIAC. The Secondary loan is intended to liquidate delayed reimbursement of contractors' costs and the surcharge to pay for this loan would be gradually reduced once the SWRCB resumes reimbursements. This is a matter that HWC has no control of.

Finally, HWC's customers are now supplied water from three modern efficient water treatment plants which are producing water that is clean, safe and now meets Federal and State drinking water standards.

AFFORDABILITY OF PROPOSED SURCHARGE RATES

With the proposed surcharge rates shown and discussed on page 17 of this Resolution, the monthly customer's bill for an average residential customer with a ¾-inch meter size using approximately 14 ccf of water will increase from \$119.89 to \$132.06, or 10.2%, which is 3.41% of the median household income (MHI) of \$46,445 for the Raymond service area, a lower middle class community and 3.65% of the MHI of \$43,376 for the Oakhurst service area, one with a more affluent demographic. When the SWRCB resumes payments and liquidates claims, the monthly customer's bill will decrease to approximately \$127.57 or 3.4%.

It should be noted that no affordability criteria have been developed and adopted in any Commission Decision or legislation. However, in October 2017, the Health and Safety Code in the California Code of Regulations (Sec. 116760.50) was amended to establish an affordability threshold of 1.50% of MHI for average water bills in Severely Disadvantage Communities, as defined (60.00% of California Statewide MHI of \$60,818, or \$37,091).¹⁴ The Commission adheres to cost-of-service regulatory principles in developing rates for its jurisdictional utilities.

WD's recommended surcharge rates for HWC are at the minimum required to satisfy the lender's requirement for a dedicated source of payment for the loan. The discussion regarding affordability is presented to indicate to the Commission the relationship between the proposed surcharge rates and local incomes.

¹⁴ See Assembly Bill 560 (Salas); Chaptered by Secretary of State on October 7, 2017 – Chapter 552, Statutes of 2017.

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FEES

Whenever the Commission authorizes a utility to issue debt, the Commission is required to charge and collect a fee in accordance with Public Utilities Code § 1904(b).

The fee for this financing authority as required by Public Utilities Code § 1904(b) is \$4,413.¹⁵

SAFETY AND COMPLIANCE

As discussed above, the SWRCB issued HWC compliance orders for not meeting the primary drinking water standards. HWC's treatment facilities constructed with grant funds provided HWC the means to comply with the order to meet all applicable water quality standards set forth by the SWRCB. HWC pays the Commission User Fees and files its Annual Reports regularly. There is no safety implication associated with AL No. 119, as supplemented.

COMMENTS

Public Utilities Code § 311 (g) (1) generally requires that draft resolutions be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission.

Accordingly, on April 12, 2019, the draft resolution was mailed to parties based on the service list attached to AL No. 119, as supplemented, with comments due on May 2, 2019.

No comments were received.

FINDINGS AND CONCLUSIONS

1. HWC is responsible for maintaining its quality of service and providing necessary improvements to its water system.

¹⁵ The fee is assessed on \$3,412,499 of authorized borrowing as follows: \$2 times (\$1,000,000/\$1,000) + \$1 times (2,412,499/\$1,000) equals \$4,413.

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2. In 2014, HWC's Oakhurst (Sierra Lakes, Forest Ridge) and Raymond water systems are under compliance orders from the SWRCB for not meeting the primary drinking water standards.
3. To-date, HWC received grant funds in the amount of \$9,999,997 under Prop 84, \$3,326,496 under Prop 50, and \$203,667 under PDE.
4. Grant funds provide the utility and its customers cost-free funds for needed investments in water supply, treatment, and security.
5. Both HWC's Coarsegold and Goldside water systems will benefit from the projects funded by the grants.
6. Pursuant to the Act, contribution such as cash grants, public infrastructure and improvement grants from governmental entities are now taxable.
7. Because of the Prop 50, Prop 84, and PDE grants, HWC needs to declare approximately \$7.3 million in taxable income and pay approximately \$2.2 million in taxes.
8. The SWRCB reimbursement of vendor's costs are suspended temporarily and approximately \$1.2 million of HWC's contractor's costs remain unpaid and are currently due.
9. The SWRCB suggested that HWC procure a bridge loan to enable payment to vendors pending release of grant funding.
10. HWC currently has no ability to collect from the grant funding agency the income tax caused by the receipt of grant funds after December 22, 2017.
11. HWC does not have the financial ability to pay the tax associated with the grant funds required by the Act and the outstanding costs now due to vendors that are part of the Prop 50 and Prop 84 grant funds.
12. HWC requests authority to finance the tax liability and outstanding vendor's cost and implement a surcharge.

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13. Once the SWRCB resumes payments of the outstanding contractors' costs, HWC shall use all the reimbursement amounts as payments to the Secondary loan.
14. The proposed Secondary loan surcharge will be temporary in nature and shall be terminated as soon as the outstanding contractor's costs plus loan costs are fully liquidated.
15. With a surcharge type of recovery, the utility or its owners do not personally benefit from the loan.
16. The surcharge method of recovery ensures that the loan will be repaid without financial stress to the water utility.
17. The Commission has required utilities to impose a service fee for new service to currently vacant and undeveloped lots when the Commission authorizes surcharge recovery.
18. The service fee serves to recover some of the costs from future customers who will benefit from the system improvements. By this, the costs are distributed to a larger base that may lead an overall future decrease in surcharge.
19. The periodic review of the trust account is the mechanism that should be relied upon to adjust any actual over or under collection. Overcollections are refunded to customers.
20. In 1990, the California legislature made contributions taxable for CCFT purposes, and any tax gross-up in 1990 and subsequent years will include a CCFT component, as well as a FIT component.
21. Since the California Franchise Tax Board has not yet conformed to the taxability of grants, the Commission will require in this financing authority the conditions shown on page 20 of this Resolution.
22. While the Commission does not look with favor upon the capitalization of operating expenses and the cost of maintaining service, it has the power and will, in extraordinary cases, authorize securities for that purpose.

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23. Public Utilities Code § 829 (c) provides that the Commission may from time to time by order or rule, and subject to such terms and conditions as may be prescribed therein, exempt any public utility or class of public utility from Article 5. Stocks and Security Transactions, if it finds that the application thereof to such public utility or class of public utility is not necessary in the public interest.

24. The SWRCB's DDW has verified the construction and specifications of the projects funded by the grants and gave HWC conditional approval to operate the newly constructed Raymond, Sierra Lakes, and Forest Ridge water treatment plants.

25. The customer's protests did not provide any substantive evidence or reason for this Commission to reject HWC's proposed loans and surcharge rates.

26. The free grant funds that were used for the construction of three modern water treatment plants are in the best interests of HWC's ratepayers.

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THEREFORE, IT IS ORDERED THAT:

1. Hillview Water Company, Inc. is authorized to borrow up to \$3,412,499 to pay the tax liability arising from receipt of Prop 50, Prop 84, and Program Drought Emergency grant funds and liquidate outstanding construction costs pending receipt of reimbursement from the State Water Resources Control Board.
2. Hillview Water Company, Inc. is authorized to encumber utility assets to secure the loan.
3. Hillview Water Company, Inc. is authorized to impose a surcharge on its customers as set forth herein.
4. Hillview Water Company, Inc. shall file a Tier 2 Advice Letter to implement a surcharge and service fee at an appropriate time prior to the first loan payment and include in the filing a request to establish two balancing accounts. The filing shall include the loan amortization schedule, lender's requirement for a dedicated source of payment, the calculation of the surcharge, and tariff sheets, updated for the correct amounts.
5. The authority granted herein shall be subject to the conditions enumerated on pages 19 and 20 of this Resolution.
6. If Hillview Water Company, Inc. collects a gross-up using an incremental tax rate that is more than its incremental tax rate as determined on a taxable year basis without consideration of a tax credit or tax loss carry forwards, the difference between what was and what should have been collection shall be refunded to the ratepayers.
7. As appropriate and on a timely basis, Hillview Water Company, Inc. shall update its Main Extension, Rule 15 to reflect changes in FIT and CCFT components for purposes of the tax gross-ups for contributions and advances.
8. Hillview Water Company, Inc. shall maintain records to (i) identify the specific long-term debt issued pursuant to this Resolution, and (ii) demonstrate that the proceeds from such debt have been used only for the purposes authorized by this Resolution.

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9. The authority granted by this Resolution shall become effective when Hillview Water Company, Inc. pays \$4,413 as required by Public Utilities Code § 1904(b). Hillview Water Company, Inc. must issue the check payable to the California Public Utilities Commission and remit the payment to the Commission's Fiscal Office.

This Resolution is effective today.

I certify that the foregoing Resolution was duly introduced, passed, and adopted at a conference of the Public Utilities Commission of the State of California held on May 16, 2019; the following Commissioners voting favorably thereon:

ALICE STEBBINS
Executive Director

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HILLVIEW WATER COMPANY ADVICE LETTER NOS. 119, 119-A SERVICE LIST

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